Yannis Stournaras: What happened to incentives and market discipline?

Talking points by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Session "Low for long again? Central bank balance sheets large forever? What happened to incentives and market discipline?", at the Eurofi High Level Seminar, Ghent, 23 February 2024.

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General remarks on monetary policy

Monetary policy conduct in the euro area has to take several factors into account:

- First, the European Union institutional architecture is still incomplete in several fields, which importantly include the Banking Union.
- Second, the lessons learnt from past crises: monetary policy needs to be flexible, in order to ensure the smooth transmission of monetary policy in the euro area.
- Third, the euro area banking system remains fragmented across and within jurisdictions. Monetary policy can play a significant role in limiting the risk of adverse market dynamics and the associated fragmentation risks, thereby helping to preserve financial stability.
- Fourth, uncertainty remains extremely high, with significant contribution from adverse international and geopolitical developments.
- Two principles need to guide our actions: first, realism and, second, gradualism.
- The response of monetary policy to the new circumstances should be data-dependent and state-dependent. In other words, the assessment of the way forward needs to be continuous and meticulous.
- Furthermore, any adjustments in the conduct of monetary policy have to follow a gradual approach, in order to avoid disorderly movements in the markets.
- This includes not only the relevant interest rate decisions, but also developments relating to the market footprint of the central bank (i.e. the balance sheet size of the Eurosystem).

Are we returning to a world where real interest rates are at zero? What lessons should be drawn from the many years of negative policy rates and easy money?

- As a result of the disinflationary process, an adjustment in the policy rates is coming due; therefore, real interest rates can be expected to decline again towards lower levels. In this connection, let me reiterate that the monetary policy decisions of the Governing Council, including the decisions on policy rates, are presently data-dependent and take into account the assessment of the inflation outlook.
- In the medium term, what matters for the economy is the evolution of the natural rate of interest (r*), driven mainly by structural factors. We know that different forces impact on the natural rate of interest, such as demographic changes and the decline of total factor productivity, deglobalisation, artificial intelligence, as well as the green transition and climate change adaptation policies.

- Given the uncertain overall impact of these effects and the significant unknowns and ambiguity surrounding the computation of natural interest rates, their prospective level and evolution are not easily determined.
- Turning now to the lessons learnt, experience gained during the past crises has been extremely valuable.
- First, monetary policy needs to remain flexible so that it can accommodate potential future shocks to price stability, of any nature and direction.
- Second, financial stability considerations need to be taken into account in the decision making of monetary policymakers, in their pursuit of price stability.
- The past decade provided us with new insights into what monetary policy can do. We are now better prepared to implement the appropriate monetary policy mix, with standard and non-standard tools, if we were to face new challenges. We have a better understanding of what works and how to reduce possible side effects on the financial system.
- The provision of ample liquidity through non-standard measures in the context of the low interest rate environment contributed both correctively and preventively on the macroeconomy and the financial system. Specifically:
- it alleviated impairments in the policy transmission mechanism;
- it safeguarded the smooth functioning of the financial system and strengthened the bank lending channel;
- it mitigated the negative impact of the financial sector turmoil on the economy;
- it helped the euro area emerge from a crisis that threatened the Monetary Union's existence; and
- it minimised recessionary risks, while ensuring price stability.
- At the same time, the prominent role of macroprudential and supervisory policies has been brought out during the past few years. By addressing risks to financial stability and increasing the resilience of the financial sector, these policies have supported the smooth transmission of monetary policy impulses and have contributed to price stability over the medium term.
- All in all, the resilience of the euro area financial sector has improved markedly and provides a cushion to future crisis episodes. Several measures have contributed to this direction, such as, for instance, the establishment of the (still incomplete) Banking Union, with the Single Supervisory Mechanism and the Single Resolution Mechanism at its core.
- However, let me express my firm belief that we need *more* Europe; as integration and policy coordination in the monetary union progress – and with the completion of the Banking Union, which I consider of paramount importance – the euro area economy and its financial system will become increasingly resilient to future shocks and adverse geopolitical developments.

With the long period of easy money inflating asset prices and fueling the financialization of economies, how serious are the resulting financial stability risks?

- Overall, I believe that, in the absence of an accommodative monetary policy, financial stability risks during the period under review would have been significantly higher compared with what was actually the case, for the following reasons.

- First, low interest rates and the non-standard monetary policy measures considerably improved financing conditions, with a positive impact on macroeconomic performance.
- In this regard, various studies[1] provide evidence that the negative interest rate policy had a positive impact on the growth of loans granted to firms. At the same time, the favourable effects of low interest rates on economic activity led to fewer non-performing loans and to a reduction in loan-loss provisions.
- Second, in the absence of these standard and non-standard measures, that reinforced each other, inflation and growth would have been much lower, while the resilience of the financial system would have been compromised. As Mario Draghi put it in 2016,[2] "if we had not acted in recent years, the counterfactual[3] would have been a disastrous deflation."
- All in all, the substantial easing in the ECB's monetary policy has significantly blunted the negative effects on the economy from a series of shocks. It has succeeded in escaping deflation and avoiding a recession and, at the same time, it strengthened the functioning of the financial system. Indeed, the euro area financial system has emerged much stronger than before the crisis.
- However, such extensive measures do not come without potential costs or side effects for banks. Next, I will refer to some of them:
- Interest rates close or below zero implied a lower interest margin, decreased profitability and reduced net worth of banks. Subdued prospects about net interest income took their toll on banks' market valuation.
- The low interest rate environment prompted investors and financial institutions to seek higher yields, resulting in reduced risk premia and more maturity mismatches. Compressed risk premia can, in turn, encourage leverage and funding misallocation, potentially disrupting the process of restructuring in the corporate sector.
- Improved liquidity conditions, combined with low funding expenses, have facilitated access to lending for firms and households. In the current situation characterised by restrictive monetary policy and weak economic growth, high debt levels could result in new waves of non-performing loans, impacting both the financial health of banks and the quality of their assets.
- The non-bank financial sector has grown considerably in both size and significance; however, it is not as tightly regulated as the banking sector.
- Last but not least, the overvaluation of real and financial assets could increase the probability of abrupt and widespread corrections in asset prices and thus transform into a systemic risk.
- Having said that, it is important to highlight that a number of monetary policy measures implemented by monetary authorities also contributed to alleviating the impact of the low interest rate environment on the banking sector. Examples include the introduction of a two-tier system for remunerating credit institutions' excess reserves, as well as the remuneration on TLTROs linked to the achievement of lending targets.
- Finally, banks' profitability was underpinned by increased asset values and stronger economic outcomes. As mentioned above, in the counterfactual, the consequences on bank lending and loan servicing would have been severe, with adverse implications for banks' revenues and cost of credit risk. The same applies to the non-bank financial sector.

Is it already decided that central bank balance sheets must remain large forever? What are the tradeoffs of a large structural bond portfolio?

- Let me first say that these issues are part of the review of the ECB's operational framework and are still under discussion at the Governing Council. These issues have to be addressed in a holistic way. We plan to publish the outcome of our deliberations in spring.
- The views I will express today do not necessarily reflect those of the Governing Council.
- Starting from the balance sheet, we expect that, in the steady state, the Eurosystem balance sheet will be significantly smaller than it is today, but still larger compared to its pre-crisis levels.
- Although demand for reserves from banks is volatile and hard to forecast, there are reasons to anticipate that, in the steady state, banks will demand a materially higher level of excess reserves than before the financial crisis, due to the following:
- First, supervisory regulation, which is likely to translate into increased demand for liquidity.
- Second, banks, in the wake of the global financial crisis, have maintained a precautionary stance. To guard themselves against liquidity and counterparty risks, they show hesitance about lending each other. This places obstacles to the efficient redistribution of reserves not only across, but also within jurisdictions, giving rise to local reserve scarcity and cross-border segmentation.
- Therefore, a substantial amount of reserves will need to be provided through a mix of credit operations and a structural portfolio[4], which is an option considered in our review of the ECB's operational framework.
- Turning now to the features of a structural portfolio:
- It can channel liquidity effectively and efficiently to counterparties across the euro area and smooth disturbances to liquidity conditions, containing interest rate volatility and facilitating the efficient transmission of policy interest rates to the operational target.
- It allows the Eurosystem discretion in the provision of a given level of reserves deemed necessary to transmit monetary policy impulses.
- The provision of sufficient liquidity in a cost-efficient manner can prove effective in preventing financial tensions.
- Reserves offered to banks via purchases could also encourage some liquidity redistribution and thereby improve the functioning of the interbank market.
- However, a large structural assets portfolio contributes to a stronger financial market footprint for the Eurosystem. To limit this footprint and alleviate potential distortions in market pricing, certain design elements can be considered. To give an example, tilting the portfolio towards shorter maturities (up to 10 years) is an option. Moreover, setting up a securities lending facility may alleviate collateral scarcity.
- I am confident that at the Governing Council, we can design and implement a structural portfolio of a size, composition and duration that can adequately address banks' high liquidity needs, while catering for the potential side effects.

Will central bank loss-making, even if temporary, pose a threat to central bank independence and limit the freedom of policy manoeuvre going forward?

- Importantly, central banks are public institutions with a specific mandate and are not profit-oriented.
- Our primary objective is to maintain price stability. The recent losses are a side effect of the policies we have adopted in the previous years to bring inflation back to target. These losses cannot jeopardise our ability to deliver on our mandate.
- Our independence is not affected by losses, since they were in part covered by profits generated in the past and would be offset in future years.
- As President Lagarde has said[5], central banks could neither go bankrupt nor run out of money.
- In the case of the ECB and of several other central banks, losses would only be temporary and significantly lower compared to the potential macroeconomic costs that could have emerged if we hadn't addressed decisively challenges to price stability and risks of recession.

Is the drying up of the unsecured interbank market a price worth paying for lower interest rate volatility and tighter interest rate control in the money markets?

- At present, it is difficult to envisage how the unsecured interbank money market could be revived in full in the near future, reaching the pre-global financial crisis levels.
- This is due both to regulatory reasons and to fragmentation.
- Post-crisis, banks appear reluctant to lend each other in the unsecured interbank market, pricing such lending at levels that are sufficient to compensate for counterparty credit risk. At the same time, short-term (below 6 months) interbank funding does not contribute towards satisfying the NSFR requirements. As a result, the unsecured segment of the interbank market is unattractive for prospective borrowers and is not expected to regain importance.
- Furthermore, heterogeneity within and across the banking systems of euro area countries impedes the efficient redistribution of reserves across banks and jurisdictions, giving rise to local reserve scarcity and cross-border segmentation.
- Although certain choices in terms of the operational framework might be more effective than others in encouraging interbank market activity, my impression is that the unsecured interbank market will not resume the activity evidenced prior to 2008. In any case, the choice of the appropriate set-up of the operational framework should follow a holistic approach, as explained previously.
- The secured interbank market, on the other hand, could redistribute liquidity to a sufficient degree. However, operational complexity and costs imply that not all banks, particularly smaller ones, can be active in that segment.

Ultimately, will the ECB's operational review be used to justify a large structural bond portfolio, the true purpose of which would be to support weaker member states?

- Let me first highlight that monetary financing is prohibited by the Treaty.
- The review of the operational framework has been deemed necessary, in order to optimise the efficient transmission of policy rates, thus steering market rates towards intended levels. We are still elaborating on the defining parameters of the operational framework. We plan to publish the outcome of our deliberation on this review in spring.
- Overall, asset purchases are an important part of our toolkit.
- By now we have gained extensive experience with the use of this instrument and have, in my view, always used it wisely to meet our price stability objective.
- As my colleague at the Governing Council, Isabel Schnabel, explained very well in her recent interview with the Financial Times,[6] asset purchases serve three objectives. The first is market stabilisation, the second is monetary policy accommodation and the third is monetary policy implementation. A structural assets portfolio provides liquidity to the financial system, thereby serving the third objective.
- As I mentioned, demand for excess liquidity by banks has increased significantly and is expected to remain elevated, not only due to new regulation, but also due to the diverse and fragmented euro area banking system.
- A structural asset portfolio can ensure the provision of the required amounts of liquidity to the system, thereby efficiently limiting fluctuations in the markets.
- The above provide support for having a structural asset portfolio for monetary policy reasons and not for fiscal ones.
- To contain duration extraction and address possible interference with the monetary policy stance, some tilting towards shorter maturities could be considered. The distribution of holdings according to capital key and other safeguards, such as purchases in the secondary market, and issue and issuer limits, have already been applied in the past. Such measures are intended to ensure that purchases do not undermine incentives for Member States to maintain sound budgetary policies.
- Although our final decision on the steady state operational framework is still pending, I trust that if a structural bond portfolio is introduced, the Governing Council will take a holistic view, ensuring its appropriate calibration.

If this were to be the best choice from a fragmentation perspective, would it be better to acknowledge the moral hazard rather than to shroud the matter in technicalities?

- As I just said, the ECB strictly adheres to the prohibition on monetary financing.
- The best choice from a fragmentation perspective is for the ECB to continue using its discretion to conduct monetary policy within its mandate. This enables the effective pursuit of the objective of price stability and ensures the smooth operation of the monetary policy transmission mechanism across jurisdictions.
- Discretion without limits may of course increase the risk of arbitrariness and contribute to loss of credibility. There are constitutional red lines for our actions.
- We have self-imposed constraints to our programmes, so as to be able to control this discretion in accordance with the rulings of the European Court of Justice.
- Such constraints include issue and issuer limits, purchases according to capital key, as well as maturity limits. They can serve as an indication for the safeguards that could be applied to a structural portfolio, should it be eventually decided.

- We have always used purchases in a measured and proportionate manner, to ensure compliance with the Treaties, while achieving a smooth transmission of monetary policy impulses across the euro area.

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[1] According to the article entitled "Negative rates and the transmission of monetary policy", ECB, Economic Bulletin, Issue 3/2020, empirical studies suggest a positive impact on loan growth of around 0.7 percentage points each year, attributed to the negative interest rate policy.

[2] https://twitter.com/ecb/status/707936983239299073

[3] According to ECB estimations under a counterfactual exercise, inflation, in the absence of non-standard measures, would have been between 0.3 and 0.5 percentage points lower per year in the period 2015-2019, while real GDP would have been between 2.5 and 3.0 percentage points lower than the observed level in the end of 2019.

[4] See "Central bank liquidity: a macroeconomic perspective", welcome address by Philip R. Lane at the ECB Conference on Money Markets, 9 November 2023.

[5] See Monetary dialogue with Christine Lagarde, Committee on Economic and Monetary Affairs, 19 November 2020.

[6] See Interview with Isabel Schnabel, conducted by Martin Arnold for the Financial Times on 2 February 2024 and published on 7 February 2024.